



# KPMG report: Summary and initial analysis of Pillar One Blueprint

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# Introduction and overview

The OECD/G20 Inclusive Framework on BEPS on October 12, 2020, released its Report on the Pillar One Blueprint (the “Blueprint”), part of its two-pillar approach to addressing the tax challenges of the digitalization of the economy. The [Pillar One Blueprint](#) [PDF 4.8 MB] (232 pages), which was discussed at the October 8-9 meeting of the Inclusive Framework, reflects the latest stage of this work, and is meant to provide a basis for political agreement across the Inclusive Framework.

The three primary components of Pillar One are Amount A, Amount B, and the development of dispute prevention and resolution mechanisms that will promote tax certainty. Amount A would apply a formulary approach to allocate a portion of a multinational enterprise’s (“MNE”) deemed residual profits to market jurisdictions, and provide those jurisdictions with nexus for taxing that allocation. Amount B would provide a fixed return for certain baseline marketing and distribution activities that is intended to be consistent with the arm’s length principle. To increase tax certainty, the Blueprint outlines a proposed approach to mandatory binding dispute prevention and resolution for Amount A and explores approaches to enhance dispute prevention and resolution more broadly.

## Contents

<b>Introduction and overview</b> .....	1
<b>Chapter 2: Scope of Amount A</b> .....	2
ADS .....	2
CFB .....	3
Exclusions .....	4
Safe harbor proposal .....	4
Thresholds .....	4
<b>Chapter 3: Nexus for Amount A</b> .....	5
Nexus for ADS .....	5
Nexus for CFB .....	5
<b>Chapter 4: Revenue sourcing rules for Amount A</b> .....	6
General structure .....	6
Documentation .....	7
<b>Chapter 5: Amount A tax base</b> .....	8
Use of financial statements .....	8
Segmentation of revenue .....	8
Use of segmented financial accounts .....	9
Loss carryforwards .....	9
<b>Chapter 6: Profit allocation</b> .....	10
Quantum of Amount A .....	10
Differentiation mechanisms .....	10
Marketing and distribution profits safe harbor .....	11
Domestic business exemption .....	11
<b>Chapter 7: Elimination of double taxation</b> .....	12

Component 1: Identify the paying entities .....	12
Step 1: Activities test .....	12
Step 2: Profitability test.....	12
Step 3: Market connection priority test .....	13
Step 4: Pro rata allocation .....	13
Component 2: Methods to eliminate double taxation.....	13
<b>Chapter 8: Amount B</b> .....	14
Amount B scope .....	14
Fixed returns for “in-scope” activities .....	15
Rebuttable presumption.....	15
<b>Chapter 9: Tax certainty</b> .....	15
Administration of Amount A.....	15
Optional request for certainty.....	16
Panel process .....	16
In-scope and market jurisdiction procedures .....	17
Dispute prevention and resolution for Amount B.....	17
Dispute prevention and resolution beyond Amounts A and B .....	17

## Chapter 2: Scope of Amount A

The question of Amount A’s scope remains a key political issue subject to agreement. The Blueprint lays out a system under which a business would be within the scope of Amount A if it performs in-scope activities and meets certain thresholds. In-scope activities under the Blueprint include both automated digital services (“ADS”) and consumer-facing businesses (“CFB”). The contemplated thresholds are a global consolidated revenue threshold and a foreign in-scope revenue threshold.

### ADS

ADS is defined to encompass services that are both automated (i.e., require minimal human involvement following set-up) and digital, but this broad general definition is supplemented by positive and negative lists that clarify the treatment of many common services. MNEs that fall outside the ADS definition may still be in-scope under the CFB test.

The positive list of services that *per se* qualify as ADS covers nine categories:

- Online advertising services;
- Sale or other alienation of user data;
- Online search engines;
- Social media platforms;
- Online intermediation platforms;
- Digital content services;
- Online gaming;
- Standardized online teaching services; and
- Cloud computing services.

The negative list of services that would not be considered ADS includes five categories:

- Customized professional services;
- Customized online teaching services;
- Online sale of goods and services that are not themselves ADS;
- Revenue from the sale of a physical good, even if it has “Internet of Things” connectivity; and
- Services providing access to the Internet or another electronic network.

The Blueprint indicates that rules for bundled services that are only partially within the ADS definition are under consideration.

### KPMG observation

The ADS definition under the Blueprint is significantly broader than European Union-style digital services taxes (“DSTs”), and includes cloud services, first-party provision of digital content, and standardized online teaching services. The expansion in scope may be necessary to entice governments to repeal their DSTs, but may also reduce support among businesses that otherwise would not be impacted.

### KPMG observation

The positive list includes standardized cloud services, but specifically excludes customized cloud services. Distinguishing standardized cloud services (in-scope) and customized cloud services (out-of-scope) may be challenging without further guidance regarding the dividing line.

### KPMG observation

The Blueprint suggests that a taxpayer may be required to unbundle transactions to identify elements that are in scope and elements that are out of scope. Such rules could significantly increase the complexity of Amount A and lead to many more disputes about whether a business activity is in scope or out of scope.

## CFB

CFBs are defined as businesses that generate revenue from the sale of goods or services of a type commonly sold to consumers, or that license or exploit intangible property connected with the supply of such goods or services. The latter prong of the definition brings some franchising and licensing businesses within the scope of Amount A. For pharmaceuticals, the Blueprint proposes two options: all drugs may be in scope, or only those sold over-the-counter.

CFBs are not restricted to businesses that sell goods directly to consumers, and include businesses that operate through brokers, third-party distributors, or other intermediaries. Thus, even revenue from sales to business customers may be in-scope under the CFB definition, provided the goods or services in question are of a type commonly sold to consumers. However, the CFB definition applies only to (i) the MNE whose “face” is presented to the consumer, and (ii) the retailer or contractual counterparty of the consumer. Other third-party businesses that do not have a relationship with the consumer (e.g., manufacturers, wholesalers, and distributors) are not considered CFBs.

The Blueprint provides a special rule for intermediate products and components of a type that may either be sold to consumers or sold to businesses for incorporation in a finished product (e.g., batteries or car tires). Sales of such products would fall within the scope of Amount A only to the extent of sales to consumers. By contrast, sales of services or finished goods that meet the CFB criteria are considered in-scope regardless of whether some are sold to business customers.

## Exclusions

Proposed exclusions would take some industries out of the scope of Amount A. These include natural resources; financial services; infrastructure and construction; and international airline and shipping businesses. Further work will be conducted on whether financial technology (“Fintech”) businesses would be included in the financial services exclusion.

### KPMG observation

The financial services exception is broad, but not well defined. For example, if a regulated financial services business engages in unregulated activity that is otherwise in scope (such as selling user data), it is unclear whether that activity would fall within the scope of the exclusion or would need to be unbundled.

## Safe harbor proposal

The Blueprint also recognizes the U.S. proposal that Amount A apply on a safe harbor basis. Under this proposal, MNEs would be able to “opt-in” to Amount A as a means to achieve enhanced tax certainty. This alternative could eliminate the need to reach agreement on the ADS and CFB definitions. The Blueprint notes that other jurisdictions have expressed skepticism about this proposal.

### KPMG observation

Although the United States has argued against ring-fencing the digital economy, the U.S. safe harbor proposal could result in *de facto* ring-fencing, if other jurisdictions do not repeal their DSTs but provide relief from DSTs for businesses that elect into Amount A. In that case, the businesses that elect into Amount A are likely to be primarily businesses that are targeted by the DSTs.

## Thresholds

While the determination of the global revenue threshold for Amount A remains an open political question, the Blueprint indicates that applying a threshold below the €750 million Country-by-Country reporting (“CbCR”) threshold would entail sizeable administrative burdens and result in only limited revenue gains. The OECD calculates that approximately 2,300 MNEs would be within the scope of Amount A if the CbCR threshold were adopted. Alternatively, the threshold could be implemented using a phased approach, beginning with higher thresholds in the initial years.

In addition, a separate foreign in-scope revenue threshold would apply. This would serve to remove MNEs with largely domestic businesses from the scope of Amount A. Further work will be undertaken to define an MNE’s domestic market for purposes of this rule.

## Chapter 3: Nexus for Amount A

The Blueprint proposes new nexus rules, which would permit market jurisdictions to tax Amount A allocations, but would not affect nexus determinations for other tax purposes. The nexus rules would be designed as a stand-alone provision to limit spill-over effects in other areas. Different nexus rules could apply for ADS and CFB.

### Nexus for ADS

For ADS, nexus would be determined solely based on the MNE's revenues in the market jurisdiction. While the market revenue threshold that would be applied is the source of ongoing discussion, it is expected to be set below €5 million. The Blueprint reflects the view that the nature of ADS enables ADS businesses to have a significant and sustained engagement in a market without any physical presence, justifying the creation of nexus solely on the basis of market revenue.

The market revenue threshold would apply only to in-scope revenues in the market jurisdiction, and could be applied separately for ADS and CFB. Where a group applies segmentation for Amount A tax base purposes, nexus would be assessed at the segment level. Further work will be undertaken to determine whether a temporal requirement should be added to the market revenue threshold (e.g., a requirement that the market revenue threshold be exceeded for multiple consecutive years).

### Nexus for CFB

Unlike ADS, CFBs are less able to participate remotely in market jurisdictions. For this and other policy reasons, the Blueprint indicates that a higher nexus standard could apply to CFBs. This could be achieved by applying a market revenue threshold in conjunction with the requirement that one or more "plus factors" exist. As with ADS, the revenue threshold remains to be determined, but it is expected to be less than €5 million.

The Blueprint identifies "physical presence" in the form of a subsidiary or permanent establishment ("PE") in the market jurisdiction as a possible plus factor. In addition, the satisfaction of a higher market revenue threshold could function as a plus factor, among other plus factors that may be considered. The existence of a PE in the market jurisdiction would be determined using a self-standing "group-permanent establishment" definition, rather than by relying on PE definitions in tax treaties or domestic law. This group-PE test would be based on the commonalities of the PE definitions in the UN and OECD model income tax conventions, though further work would be needed in certain areas.

Further work will also be required to determine if, for purposes of satisfying the physical presence test, the activities of the group-PE or subsidiary in the market jurisdiction must be connected with in-scope revenues. In addition to distribution activities, the Blueprint notes that such activities could include:

- Facilitating billing and payment in the local currency;
- Collecting indirect taxes and duties;
- Transportation;
- Maintenance of local stock;
- Cross border delivery;
- After-sales support;
- Repair and maintenance;
- Advertising and promoting; and

- Adapting product or services to the particular market.

### KPMG observation

- The group-PE definition is not intended to affect the application of PE rules in existing tax treaties or domestic legislation, but it may be difficult to effectively divorce these concepts.
- If the physical presence test requires the group-PE or subsidiary to be connected with in-scope revenues, this may be difficult to determine. It is unclear whether the performance of any connected activity, however minor, would constitute sufficient connection.
- The group-PE definition would be based on the UN and OECD model conventions with potential modifications. Here too, it is unclear whether those modifications would be aligned with the requirements for connection to in-scope revenues.

## Chapter 4: Revenue sourcing rules for Amount A

The Blueprint lays out detailed sourcing rules that would determine where revenue is deemed to arise for purposes of determining scope and nexus, and for making Amount A allocations. These rules vary significantly between ADS and CFB, and between different business models within those broader categories.

### General structure

The sourcing rules are intended to be applied by revenue stream, rather than by business type. For instance, the Blueprint indicates that an ADS business that falls under the “digital content services” umbrella would likely look to the rules for revenue from online advertising services, revenue from the sale of user data, and/or revenue from digital content services, depending on how the business generates revenue. For each identified revenue stream, a sourcing principle is laid out. For example, the sourcing rule for digital content services revenue is the ordinary residence of the purchaser; for revenue from consumer-facing goods sold through an independent distributor, the rule is the place of the final delivery of the good to the consumer.

To give effect to these general sourcing principles, an MNE is required to apply lists of specific indicators (e.g., geolocation, IP address, country code of user’s phone number). These indicators are laid out in a strict hierarchical fashion. For instance, the rule for digital content services looks first to user profile information maintained by the MNE that may indicate the ordinary residence of the purchaser, then to the billing address, then to the jurisdiction of the purchaser’s geolocation information, and then to the jurisdiction of the purchaser’s IP address. MNEs would be required to use the first indicator in the hierarchy where feasible; lower-level indicators could be used only if higher priority indicators were not reasonably available or would be unreliable. If no indicator can be used, an MNE would be permitted to apply the sourcing rule on an alternative basis, and would be required to document the approach taken. Information would be regarded as unavailable if it is not in the MNE’s possession and reasonable steps have been taken to obtain it, without success. In some cases, this may require an MNE to seek renegotiation of third-party contracts.

### KPMG observation

For transactions in which the customer is a business, a significant number of indicators require

obtaining information from the business customer about the location of the ultimate consumer of the good or service. As a practical matter, obtaining that required information from business customers or independent distributors is likely to be challenging, which may require MNEs to resort to indicators lower in the hierarchy or to rely on alternative data sources.

### KPMG observation

The Blueprint does not make clear the extent of “reasonable steps” that an MNE must take before it can consider information to be unavailable. The Blueprint notes, however, that further work will be conducted, with the goal of providing objective guidelines.

To pass over an indicator as unreliable, MNEs would likewise be required to justify that the indicator does not reliably reflect the sourcing principle

### KPMG observation

It is unclear what the extent of inquiry required by an MNE to determine whether information it possesses accurately reflects a sourcing principle. The Blueprint indicates that further work will be conducted in this area, including consideration of specific guidance related to the use of VPNs, situations in which a delivery address should be considered unreliable, and whether safe harbors could be used where an MNE has additional data that may support the reliability of a relevant indicator.

## Documentation

Because of consumer privacy and administrability concerns, MNEs would not be required to retain a record of all data points needed to show application of the specified indicators. Rather, MNEs would need to retain documentation showing:

- The functioning of the MNE’s internal control framework related to revenue sourcing;
- Aggregate and periodic information on results of applying the indicators for each type of revenue and in each jurisdiction;
- The specific indicator used for a given category of revenue; and
- The circumstances when an indicator lower in the hierarchy was used, including why the indicator higher in the hierarchy was not available (and the steps taken to obtain it) or was not reliable (and the information available to confirm the presence of a more reliable indicator).

This documentation, along with the MNE’s underlying approach to revenue sourcing, would be subject to review by tax administrations, including as part of the early certainty process which MNEs would be able to elect (see the summary of Chapter 9, below). It is expected that tax authorities would generally confine such review to an examination of the MNE’s quality control systems for application of the sourcing rules, and would not involve an audit of every particular transaction.

### KPMG observation

It is not clear whether a comprehensive compliance review of sourcing procedures could



realistically be undertaken as part of the tax certainty process, particularly if large numbers of MNE make use that process

## Chapter 5: Amount A tax base

Most MNEs would compute their Amount A liability using their consolidated group financial statements. Segmentation would be required in certain cases, though the Blueprint would create a rebuttable presumption in favor of using the segments disclosed in the MNE's financial statements. Loss carryforward rules would apply at the group or segment level.

### Use of financial statements

The tax base for Amount A would be a standardized measure of profit before tax ("PBT") computed on the basis of an MNE's consolidated financial accounts. Consolidated financial accounts prepared under International Financial Reporting Standards ("IFRS") or generally accepted accounting principles ("GAAP") that are deemed to produce equivalent or comparable outcomes to IFRS, which the Blueprint terms "eligible GAAP," would generally be used. Eligible GAAP are defined to include the GAAP of Australia, Canada, Hong Kong, Japan, China, India, South Korea, Singapore, and the United States. Consistent with the approach taken for Pillar Two, no book-to-book harmonization adjustments would be adopted to account for differences between permissible sets of GAAP.

MNE groups that do not use IFRS or a set of eligible GAAP may use other GAAP authorized in the jurisdiction of the MNE's ultimate parent, as long as use of the other GAAP does not lead to material competitive distortions when applying Amount A. Further work will be done to define what constitutes a material competitive distortion. MNEs that do not prepare consolidated financial statements would be required to prepare such statements for Amount A purposes.

Because most GAAP do not define PBT, the standardized PBT measure for computing Amount A would start from the total profit or loss figure from the MNE's consolidated profit or loss statement and make certain book-to-tax adjustments. These would exclude income tax expenses, dividend income, gains or losses from the disposal of stock, profit or loss from the equity method of accounting, and expenses that are typically not deductible on public policy grounds (e.g., bribes, fines, and penalties).

Further work is needed in a number of areas, including the treatment of dual-headed MNE groups, the effect of changes in accounting estimates and prior period errors, income from joint ventures, and others.

### Segmentation of revenue

The Blueprint would require all MNEs to segment their revenue between ADS, CFB, and out-of-scope activities for purposes of applying the scope and nexus rules, but would not require a concomitant segmentation of cost. Instead, the Amount A tax base would be calculated on the basis of consolidated or segmented accounts, as explained below, and the Amount A allocation formula would be used to allocate to market jurisdictions only those profits that are deemed to be related to in-scope revenues. The Blueprint acknowledges that this approach uses the consolidated or segmented profit margin as a proxy for the in-scope profit margin.

## Use of segmented financial accounts

Whether an MNE would be permitted or required to employ segmented rather than consolidated financial accounts when computing Amount A would be determined by applying several steps. First, MNEs with global revenue below a certain threshold would be required or permitted to forego segmentation. The threshold, which would be phased in over an initial period, remains to be determined, as does the issue of whether this exemption should be mandatory or should operate as an elective safe harbor.

MNEs not excluded under the first step would then need to apply segmentation hallmarks to determine whether they must employ segmented accounts for Amount A purposes. These hallmarks are yet to be determined, but might be based on the now-superseded guidance of International Accounting Standard (“IAS”) 14, which supplied a set of factors for determining whether segmentation should be applied and preceded the more flexible approach currently adopted under IAS 8. MNEs with regional management could be required to segment on a regional basis, though the Blueprint acknowledges that this may be inappropriate.

If the segmentation hallmarks indicate that segmentation is required, the Blueprint would apply a rebuttable presumption in favor of using the MNE’s existing segments (if any) laid out in its financial statements. A separate rebuttable presumption would provide for the allocation of any central costs among these segments on the basis of revenue. The Blueprint indicates that, where the segmentation hallmarks are met but the MNE’s segments have comparable profit margins, it could be appropriate to apply Amount A on a group basis to reduce compliance burdens.

MNEs not permitted to use their existing segments would be required to apply Amount A on the basis of alternative segments. The Blueprint indicates that this should be the case for only a “few groups.”

## Loss carryforwards

Loss carryforwards would be maintained at the group or segment level, depending on whether the MNE is required to apply segmentation, and would operate through an earn-out mechanism with the aim of only taxing economic profit. This carryforward system would be separate from any domestic loss carryforward rules. Items that remain to be decided include the extent to which this regime would apply to pre-regime losses, the treatment of profit shortfalls (i.e., profits below the profitability threshold in the Amount A formula), and the effect of business reorganizations on carryforwards.

### KPMG observations

- The Blueprint estimates that IFRS and eligible GAAP cover approximately 90% of in-scope MNEs. Even for the remaining 10%, the intent appears to be to use existing GAAP in many cases.
- The current IFRS rules provide substantial flexibility for financial reporting segmentation, and tax authorities may not agree with management’s segmentation choices.
- This risk may be particularly increased where an MNE uses a single segment to encompass business activities with materially different profit margins.
- Loss carryforward rules are necessary to tax only economic profits, but key issues remain undetermined.

## Chapter 6: Profit allocation

Amount A is a simplified proxy for the portion of the residual profit of an in-scope MNE that can reasonably be associated with the sustained and significant participation of that MNE in the economy of a market jurisdiction. The new taxing right over Amount A would operate as an overlay to the existing transfer pricing rules.

### Quantum of Amount A

Amount A will be based on a formula that is not based on the arm's length principle. The formula will apply to the tax base of the group or segment after deduction of available losses carried forward. It will involve three steps to determine the quantum of Amount A in each market jurisdiction.

The first step is a profitability threshold based on a PBT to revenue ratio, which is applied to isolate residual profit subject to reallocation. The fixed profitability threshold level is yet to be determined; however, if it is set at 10%, the OECD estimates that 780 MNEs and approximately \$500 billion of income would be subject to Amount A.

The second step is the application of a reallocation percentage to identify the share of residual profits to allocate to market jurisdictions (the "allocable tax base"). For administrative ease, the share of residual profit that is attributable to the market jurisdiction will be determined through a simplifying convention, such as a fixed percentage, and not based on the particular circumstances of the MNE group or the arm's length principle. A fixed percentage has yet to be determined; however, by applying a 10% profitability threshold and a 20% reallocation percentage, the OECD estimates that approximately \$98 billion would be allocable to market jurisdictions.

After calculating the allocable tax base for Amount A, the third step will apply an allocation key based on locally-sourced in-scope revenues to allocate Amount A amongst the eligible jurisdictions. The application of this step will be dependent upon the selection of either a profit-based or profit margin-based approach for the Amount A formula. If a profit-based approach is implemented, the allocable profit could be multiplied by a ratio of local in-scope revenue to total revenue. If a profit margin-based approach is implemented, the allocable tax base would be expressed as a profit ratio, which could then be multiplied by local in-scope revenue.

### Differentiation mechanisms

The Blueprint also considers the introduction of differentiation mechanisms to (i) account for different degrees of digitalization between in-scope business activities and increase the quantum of profit reallocated for certain types of business activities ("digital differentiation") and (ii) account for variations in profitability between different market jurisdictions, and increase profit reallocated to market jurisdictions where the profitability is higher ("jurisdictional differentiation").

The Blueprint lays out several options for digital differentiation mechanisms, including:

- No differentiation;
- Digital differentiation through adjustments to Amount A, by either decreasing the initial profitability threshold or increasing the relative size of the allocable tax base for ADS;
- Differentiation of Amount A through a profit escalator by introducing progressive bands, without distinction between the underlying activity; or

- Variations, such as adding a specific “routine return” for certain digital activities that can be conducted without any physical presence in market jurisdictions.

Jurisdictional differentiation is viewed as primarily an issue for CFB, not ADS, businesses. Although consideration has been given to whether the Amount A formula could be weighted to allocate more profits to more profitable markets, the challenges in calculating profits attributable to a market can make it difficult to accurately identify more or less profitable markets. However, the Blueprint does note several features of Amount A that are intended to prevent profits from being reallocated from more to less profitable market jurisdictions, including the mechanism to eliminate double taxation and the domestic business exemption.

## Marketing and distribution profits safe harbor

The overlay of Amount A on top of existing taxing rights could lead to duplicative taxation of the same MNE group profit in multiple jurisdictions. The marketing and distribution profits safe harbor seeks to address potential double counting by adjusting the quantum of Amount A allocated to eligible market jurisdictions in some circumstances. The safe harbor would apply where sufficient residual profit is allocated to a market jurisdiction. Rather than function as a traditional safe harbor, it would instead cap the allocation of Amount A to market jurisdictions that already have taxing rights over a group’s profits under existing tax rules. The MNE would consider the existing marketing and distribution profit for the market jurisdiction and compare it to a safe harbor return, which would be the sum of Amount A and a fixed return for in-country routine marketing and distribution activities. This gives rise to three potential outcomes:

- Where the existing return is less than the fixed return, the group is not eligible for the safe harbor.
- Where the existing return is greater than the fixed return but below the safe harbor return, Amount A is reduced to the difference between the safe harbor return and the existing return.
- Where the existing return is greater than the safe harbor return, there would be no Amount A allocated to that jurisdiction.

Centralized business models, or models allocating limited returns to local marketing and distribution activities, would not come within the scope of this safe harbor and would therefore typically pay Amount A in most market jurisdictions in which they operate. However, the safe harbor may be particularly relevant to decentralized businesses.

## Domestic business exemption

The Blueprint also considers a domestic business exemption as another option for reducing double counting. As noted above, the Blueprint proposes including a foreign in-scope revenue threshold in the scope inquiry. In addition, consideration is being given to a potential domestic business exemption, which involves identification and segmentation of parts of the business that are carried on solely in a single jurisdiction to exclude from Amount A.

### KPMG observations

- Considerable work remains to be done to determine the level of fixed thresholds to apply in the Amount A calculations.
- Nonetheless, the amount of income to be reallocated for most parameterizations is likely to be relatively small when compared to the compliance burden.
  - Example:

- Consider an MNE with in-scope revenue of €250 million and a profit margin of 20%.
- If, for the Amount A formula, 20% of the MNE's profits in excess of a 10% profit margin are allocated to the market, the MNE's residual profits would be €25 million, of which €5 million (20%) would be allocated to market jurisdictions under Amount A.
- Existing gaps between Inclusive Framework members on differentiation mechanisms appear significant and may be difficult to resolve.
- It is not clear whether and how the routine marketing and distribution profit measure that would be used for the marketing and distribution safe harbor would relate to either the fixed profitability threshold used in the first step of the Amount A calculation, or the Amount B return for baseline sales and distribution activities.

## Chapter 7: Elimination of double taxation

Because Amount A will apply as an overlay to the existing profit allocation rules under which profit is already allocated, a mechanism to reconcile the new taxing right (calculated at the level of group or segment) and the existing profit allocation rules (calculated on an entity basis) is necessary to prevent double taxation. The Blueprint outlines a mechanism to eliminate double taxation that consists of two components: (i) the identification of paying entities within an MNE group or segment; and (ii) the methods to eliminate double taxation.

### Component 1: Identify the paying entities

The first component involves identifying the entities that will bear Amount A tax liability (the "paying entities"). This component could have up to four steps, as set out below:

- Step 1: Activities test
- Step 2: Profitability test
- Step 3: Market connection priority test
- Step 4: Pro-rata allocation

#### **Step 1: Activities test**

The first step would require taxpayers to make a qualitative assessment to identify the entities that perform activities that make material and sustained contributions to the MNE group's ability to generate residual profits. The test would include a general principle describing the type of relevant activities that would be expected of a paying entity, which would be supplemented by a list of indicia, including the function, asset, and risk profile of an entity, the entity's characterization for transfer pricing purposes, and the transfer pricing method used to determine remuneration for that entity. The Blueprint notes that the master file and relevant local files prepared by MNE groups would provide a first point of reference for the application of this test.

#### **Step 2: Profitability test**

The second step would apply a profitability test to ensure the entities identified in Step 1 have the capacity to bear the Amount A tax liability, consistent with the decision to limit the application of Amount A to in-scope MNE groups that earn residual profits.

The profitability test could be aligned with the formulaic substance-based carve-out for Pillar Two, which will involve a combined payroll and tangible assets profitability test.

### **Step 3: Market connection priority test**

The activities test and profitability test will identify a pool of potential paying entities that perform non-routine activities and report residual profits in their financial accounts. A potential third step in identifying the paying entities is a market connection priority test, intended to address instances where the potential paying entities derive profits from only a limited number of market jurisdictions allocated taxing rights over Amount A. The market connection priority test would require the Amount A tax liability for a given market jurisdiction to be allocated to a paying entity that is connected to a market jurisdiction through the performance of activities identified under the activities test. For each market jurisdiction allocated Amount A, a taxpayer will be required to determine which (if any) of the potential paying entities identified have a sufficient connection to be identified as a paying entity for that market jurisdiction. Because most MNE groups have legal entity structures and legal agreements that clearly document rights to exploit intangibles and receive residual profits from specific markets, the expectation is that it will often be easy to establish a sufficient connection between a paying entity and a market jurisdiction.

### **Step 4: Pro rata allocation**

Once the taxing rights of the residence jurisdiction have been reduced to a routine return, as defined under the profitability test, a paying entity will bear no further Amount A tax liability. Where the entities that are sufficiently connected to a market jurisdiction have insufficient profits to bear the full Amount A tax liability, the other paying entities within the group or segment will be required to bear the remaining portion of the Amount A tax liability, apportioned on a pro-rata basis. This step is intended to provide a “back stop” to the first three steps.

As an alternative to the four step process, the Blueprint notes an alternative approach consisting of two steps, whereby (i) a profitability test would be used to identify entities in the group that earn residual profits; and (ii) where more than one entity is found to meet the test, the Amount A liability would be apportioned among each entity on a pro-rata basis according to the amount of profits earned by each entity that exceeds the agreed profitability threshold.

## **Component 2: Methods to eliminate double taxation**

As described above, the first component will be structured such that the entities which earn residual profits under existing rules are designated as paying entities. These paying entities may be subject to tax on the profits reflected in Amount A by their residence jurisdiction under existing tax rules and by the market jurisdiction under Amount A. The second component will address these concerns through a mechanism to eliminate double taxation through either: (i) the exemption method; or (ii) the credit method.

Under the exemption method, the paying entity exempts from taxation the portion of its profits that had been allocated to market jurisdictions under Amount A. This method would be simple to apply, as the residence jurisdiction would not need to determine the tax rate applied to the profits allocated under Amount A, but would instead look only to the proportion of the relevant paying entity’s profits reallocated under Amount A.

Under the credit method, the residence jurisdiction of the paying entity provides a credit against its own tax for the tax paid in another jurisdiction. The residence jurisdiction retains secondary taxing rights where profits are taxed at a lower rate in the market jurisdictions than in the residence country. Although more complex, some jurisdictions prefer the credit method. The Blueprint contemplates that either or

both methods could be applied, either on a jurisdiction by jurisdiction basis, or through a blended approach.

## KPMG observations

- Paying entities are not identified using the Amount A allocation methodology (e.g., PBT / revenue, in excess of x%). A DEMPE and risk analysis under the OECD Guidelines is used instead.
- There are fact patterns where the MNE group's residual profit could be concentrated in jurisdictions with no risk control or DEMPE functions. Under the rules laid out in the Blueprint, this residual profit would not be available for distribution to market jurisdictions.
  - This could be the case for cash box entities.
  - If residual profit is located in nonpaying jurisdictions, an odd fact pattern could result in which paying jurisdictions are drawn on extensively. In fact, there could be a fact pattern where there is not enough residual profit to go around.
- There is no actual mechanism for moving income from paying jurisdictions to market jurisdictions, just a mechanism for recognizing income in market jurisdictions for tax purposes.
  - As a consequence, there is no mechanism for incorporating CFC-type taxes, e.g., GILTI.
- For jurisdictions that choose to adopt a crediting method (as opposed to a participation exemption) it's unclear if there will be a uniform global crediting mechanism.
- It is expected that implementation of Pillar One in the United States could take quite some time, as layering the new rules on the existing U.S. rules will be difficult.

## Chapter 8: Amount B

In general, the proposed Amount B framework represents an attempt to establish standardized intercompany pricing for “baseline marketing and distribution activities” performed by distributors controlled by in-scope MNEs, while still adhering to the arm’s-length principle. With respect to the in-scope “baseline” activities, the advertised benefits include (i) tax administration simplification, (ii) reduction in tax compliance costs, and (iii) a potential reduction in controversies or disputes involving distribution arrangements through the application of a prescriptive or fixed return for in-scope activities.

### Amount B scope

The proposed approach envisions a multi-step process. The initial identification or classification of “baseline” marketing and distribution activities would be informed by reference to lists of “positive” and “negative” indicia of in-scope Amount B activities. This initial qualitative review would be supplemented by reference to (or comparison with) certain quantitative indicators or thresholds deemed to be consistent with in-scope distributor profiles. For example, where a distribution entity exceeds certain financial thresholds or metrics (e.g., marketing or R&D expenses exceeding a fixed proportion of total costs for the distribution entity), this may indicate that the entity is performing more than just “baseline” activities. Collectively, these referential materials and/or metrics are intended to aid in the identification of distribution entities that perform functions, own assets, and assume risks that are consistent with a routine distributor acting at arm’s length—and thus, falling within the Amount B framework.

## Fixed returns for “in-scope” activities

For distribution entities characterized as in-scope, the Amount B framework would operate to assign a fixed return for the baseline distribution and marketing activities performed by the distribution entity. For purposes of determining the fixed return, the Blueprint envisions a return on sales profit level indicator, which could be subject to adjustments to account for material differences in geographic markets and/or industries (e.g., pharmaceutical, consumer products, etc.). However, it should be noted that use of the return on sales metric (as well as the proposed adjustments) is still under review and consideration. To ensure some consistency with the arm’s-length principle, the current framework contemplates completing regional and industry-specific benchmarking studies based on publicly available information to establish an appropriate range of fixed returns.

## Rebuttable presumption

One proposal under consideration would establish a rebuttable presumption whereby all buy/sell distribution entities that perform baseline marketing and distribution activities would be considered in-scope and thus subject to the Amount B fixed return. Under this proposal, taxpayers would be afforded the opportunity to rebut the presumption by establishing that another transfer pricing method would be more appropriate (e.g., identification of a reliable comparable uncontrolled transaction). It is important to note that the use and operation of a rebuttable presumption (in this context) remains the subject of some dispute among Inclusive Framework members.

While there is some interest within the Inclusive Framework in expanding the application of Amount B beyond the narrow scope of baseline marketing and distribution activities discussed above (e.g., including sales agents and commissionaire structures), further technical work and discussion is needed to evaluate the feasibility of a more expansive approach.

### KPMG observations

- Based on the current Blueprint, it is unclear how the Amount B framework would account for instances where the Amount B fixed return assigns an inordinate share of system profit.
- Amount B envisions differentiated returns by region and industry, which will be established through benchmarking sets based on publicly available data. However, this presumes there will be a sufficient amount of comparable data available for every geographic region, which may not be the case.

## Chapter 9: Tax certainty

In addition to creating new nexus and profit allocation rules, Pillar One also provides for innovative dispute prevention and dispute resolution mechanisms. This tax certainty dimension of Pillar One is divided into two distinct elements: (1) dispute prevention and resolution for Amount A; and (2) dispute prevention and resolution beyond Amount A.

### Administration of Amount A

Amount A would be administered through a self-assessment system. An Amount A coordinating entity (the AACE) within an MNE group will file a single self-assessment return and documentation package on



behalf of the entire MNE group with its lead tax administration (the “LTA”) by an agreed filing deadline. The LTA will review and validate these materials, and will exchange them with the tax administrations of jurisdictions where the MNE has a constituent entity and those where it has market revenues that meets the applicable threshold or did so in the previous year (affected tax administrations, or “ATAs”). The ATAs and the LTA would then be free to audit the Amount A return and propose adjustments. In addition to the early certainty process described below for preventing Amount A disputes, the Blueprint notes that a mandatory binding dispute resolution mechanism will be developed.

## Optional request for certainty

An important and innovative feature of Pillar One is a voluntary procedure where all aspects of Amount A will be determined before tax adjustments are proposed by Inclusive Framework members. Once the early certainty process has been requested, ATAs should not commence any audit activity or issue assessments with respect to topics specific to Amount A for the relevant tax year pending the outcome of the certainty procedure.

When an MNE group has made a request for certainty, the LTA may conduct an initial review of the MNE group’s self-assessment return and conclude that a review by panel is not required. It may also recommend changes to the self-assessment return which, if made by the MNE group, will allow it to conclude that a panel is not required.

Where the LTA reviews recommends that a panel review is not needed, other ATAs may nonetheless request a panel review or express a preference for a panel review. If the concerns of any ATA that requested a panel review cannot be resolved, or if an undetermined number of ATAs express a preference for a panel review, then a review panel could be formed. A panel could also be formed if the LTA does not conduct an initial review of the self-assessment return, or if the LTA determines that a panel review is needed. Further work will be conducted on the circumstances under which a review panel would be formed.

Where none of these conditions are met and a review panel is not to be established, the LTA will inform the MNE group that the position set out in its self-assessment (reflecting any agreed changes) is accepted, which position is then binding on the MNE group and tax administrations in all Inclusive Framework member jurisdictions.

## Panel process

If panel review is needed, a review panel of ATAs, including the LTA, will be constituted. Although the timeline for the panel review is unclear, it appears that it should take between three and twelve months, with the average case taking approximately nine months. The panel’s conclusions would then be subject to review and approval by all ATAs, with the possibility of further revision to reflect comments raised by the ATAs.

There are three potential outcomes from the review panel process: (1) the ATAs and the MNE reach agreement; (2) the ATAs reach agreement on a basis other than the MNE’s self-assessment, and the MNE disagrees with the ATAs’ conclusion; or (3) the ATAs fail to reach agreement. In the first case, the MNE acquires tax certainty across all Inclusive Framework jurisdictions. In the second case, the early certainty process is complete, and the MNE group will need to rely on domestic remedies to resolve any Amount A disputes. It remains to be determined whether the ATAs would be bound by the resolution the MNE rejected. In the third case, where the ATAs cannot agree, the case will move to a determination panel, which is required to reach an agreement on the MNE group’s Amount A position.

Where a determination panel is required, the review panel will develop specific questions for the determination panel, together with alternative responses that reflect the different views held by the members of the review panel and the ATAs. The determination panel, the composition of which remains to be determined, will make a decision on the last best offer, choosing from these alternatives. The final determination of the panel will be binding on all Inclusive Framework members. Whether an MNE would be required to accept the determination panel's decision as a prerequisite to entering the determination panel process remains to be determined.

## In-scope and market jurisdiction procedures

Pillar One also contemplates potential procedures for in-scope determinations, which will likely only occur once or upon a material change in business for a given MNE, and market jurisdiction determinations, which would allow jurisdictions to assert that they should receive the self-assessment and documentation materials, which they can review to determine whether they should be in-scope for Amount A.

## Dispute prevention and resolution for Amount B

Disputes related to the application of Amount B (e.g., whether activities are within the scope of "baseline marketing and distribution activities") would also be subject to mandatory binding dispute resolution. However, no detail is provided on the process that would apply to Amount B disputes.

## Dispute prevention and resolution beyond Amounts A and B

There is risk that a transfer pricing adjustment unrelated to Amount A may be made after an early certainty ruling for Amount A, and such an adjustment could impact the prior Amount A determination. Pillar One provides that mandatory binding dispute resolution will be available as a backstop to existing dispute resolution tools for all disputes regarding transfer pricing and permanent establishment issues for MNE groups that are within the scope of Amount A. Developing countries meeting certain criteria would be permitted to opt out of this procedure for non-Amount A disputes. For MNE groups outside the scope of Amount A, the Blueprint indicates that consideration will be given to the respective benefits of mandatory binding dispute resolution and mandatory non-binding (i.e., advisory) dispute resolution processes.

### KPMG observations

- Existing tax conventions and tax information exchange agreements will need to be modified and supplemented to create a viable network of agreements to allow for the exchange of information envisioned by Pillar One.
- The optional review by the LTA could ultimately be one of the most important elements of the early certainty procedure, as it could screen out low risk taxpayers and eliminate the time-consuming and administratively burdensome panel process. This could be particularly important during the early years of implementing Amount A, as tax authority requests for review panels could exceed the capacity of administrations to undertake such reviews.
- No matter how many ATAs agree with the panel recommendation, a single ATA can cause the review panel process to fail and necessitate a determination panel, even if the objection is unprincipled. Hopefully, such outcomes will be rare and ATAs will generally follow the review panel determination.
- The Blueprint includes very little detail on the new mandatory binding dispute resolution

## procedures for issues not related to Amount A.

While the attention of the OECD and the Inclusive Framework to date has rightly focused on the design and development of the Pillar One components discussed above, it is important to note that any consensus-based agreement would still require the collective efforts of individual Inclusive Framework members to adopt the Pillar One components within their domestic laws and treaties before the new framework would become operational. As the Blueprint notes, these efforts would likely be aided by the adoption of a new multilateral convention, although such implementation details—as well as the broader Pillar One implementation framework—are still under review and development.

While many critical issues remain open for discussion, it is important to note that any consensus-based final agreement is expected to contain a mutual agreement by members of the Inclusive Framework to withdraw relevant unilateral measures, as well as a commitment to refrain from introducing any new measures.

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